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# Winstar, Bureaucracy and Public Choice

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*United States v Winstar ameliorates the non-simultaneity of performance problem that impedes contracting between Congress and special interest groups. In this case, a legislative bargain enabled the thrift industry to capture its regulators, and later led to private agreements in which government regulators allowed thrift operators to violate generally accepted accounting principles. After this resulted in so many undercapitalized thrift institutions that the industry collapsed, Congress abrogated these special-interest group bargains. Winstar held that the government thereby incurred massive civil liability. That outcome supports the Landes-Posner hypothesis that the independent judiciary facilitates contracting between Congress and interest groups. Winstar raises the value of the deals that interest groups make with Congress by providing them with durability, a result that is inconsistent with the interests of disaggregated citizens (taxpayers) because it will increase the frequency of wealth transfers from citizens generally to Congress and special-interest groups.*

## I. INTRODUCTION

The role of bureaucracy is poorly understood in the public choice literature. In particular, there seems to be an acute lack of consensus

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about the extent to which legislators demand control over administrative agencies, the extent to which interest groups want legislative control over agencies, and even the extent to which bureaucracies themselves can be transformed into interest groups in their own right.<sup>1</sup> Clearly, the correct starting point for analyzing bureaucracy is from a principal-agent perspective.<sup>2</sup> After all, Congress creates administrative agencies, Congress funds administrative agencies, and Congress can, if it chooses, eliminate administrative agencies.

But this seemingly simple structure masks a surprising degree of real-world complexity. In particular, the agency relationship between Congress and interest groups is characterized by three important contracting problems. First, as in other principal-agent relationships, the principals (politicians in Congress) cannot monitor their agents costlessly. As with private citizens, it is expensive for Members of Congress to inform themselves about the relevant issues and to determine which outcome will maximize their political support from affected interest groups and constituents.<sup>3</sup> Second, at the time a bureaucracy is created, interest groups may be more confident of their ability to retain control over the agency than of their ability to retain control over Congress.<sup>4</sup> Where this is the case, winning interest group coalitions will demand that Congress relinquish control over agencies. Thus, we should not expect Congress to make an effort to minimize agency autonomy in all cases. Finally, and most importantly from the perspective of this article, Congress's views on a particular policy issue will change over time, as will the relative political power of any particular interest group or coalition of interest groups. In fact, changes in power of interest group coalitions are likely to *cause* the subsequent changes in congressional preferences. Thus, monitoring and control of bureaucracies by subsequent political coalitions in Congress will not be a reliable tool for protecting the political claims previously obtained by interest groups.<sup>5</sup>

Seen from this perspective, the core problem facing interest groups and politicians at the time that a legislative deal is made is how to

<sup>1</sup> Terry M. Moe and Scott A. Wilson, *Presidents and the Politics of Structure*, 57 *L & Contemp Probs* 1, 7-11 (Spring 1994).

<sup>2</sup> Mathew D. McCubbins, Roger G. Noll and Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 *J L Econ & Org* 243 (1987) ("McCubbins, Noll & Weingast, *Administrative Procedures*").

<sup>3</sup> Jonathan R. Macey, *Organizational Design and Political Control of Administrative Agencies*, 8 *J Law Econ & Org* 93, 94 (1992) ("Macey, *Organizational Design*").

<sup>4</sup> *Id.*

<sup>5</sup> Kenneth A. Shepsle, *Bureaucratic Drift, Coalitional Drift, and Time Consistency: A Comment on Macey*, 8 *J L Econ & Org* 111 (1992) ("Shepsle, *Bureaucratic Drift*").

create a bureaucratic structure that will give durability to whatever agreement is reached. The more durable the deal, the more political support interest groups will be willing to provide in exchange for a politician's support.

This article analyzes the U.S. Supreme Court decision in *United States v Winstar*<sup>6</sup> from the perspective of the economic theory of regulation. The case is of particular interest from an economic perspective because it considered the legal limits on the ability of Congress to alter arrangements negotiated between administrative agencies and private firms. The case provides an excellent opportunity to study at close range the agency-cost problem facing Congress and interest groups and the way that bureaucracies can be used to mitigate that problem. In particular, the ability of a subsequent Congress to renege on the legislative deals made by their predecessors is of interest from a public choice perspective because it critically affects the demand by interest groups for the laws promulgated by Congress. To the extent that a subsequent Congress can renege on previous legislative bargains, such bargains will be less valuable to the relevant interest groups. And, of course, the same holds true for deals made between interest groups and the bureaucrats (who are congressional agents).

This article shows how each of the three critical characteristics of congressional control over administrative agencies described above—costly monitoring, direct control by interest groups over bureaucrats, and coalitional drift—played a role in the *Winstar* case. And, equally important, the article uses the *Winstar* decision to illustrate the role played by the Supreme Court in the bargaining game between Congress and interest groups.

In particular, the *Winstar* decision portrays the Court in the role of outside guarantor of the durability of interest group bargains arranged among Congress, administrative agencies, and the interest groups themselves. From a public choice perspective, *Winstar* raises the value of legislation engineered by interest groups by increasing its durability, and this, in turn, will lead to an increase in the demand for such legislation on the part of special interest groups. From the perspective of the public interest, the decision in *Winstar* is rather disturbing. The decision will lead to more "amorally redistributive" wealth transfers from citizens generally to Congress and members of special interest groups.

Part II describes the basic features of public choice theory that are necessary to understand the analysis in this article. Part III com-

<sup>6</sup> 116 S Ct 2432 (1996).

pletes the background by describing the particular regulatory environment that led up to the *Winstar* decision. Part IV describes the decision itself, and Part V analyzes the decision from the perspective of the well-known debate about the role of the independent judiciary in protecting the durability of interest group bargains with bureaucrats and legislators. In Part VI, I examine an alternative available to the judiciary that would raise rather than lower the transaction costs of rent-seeking. By either interpreting legislation in a manner that shapes it into only a public-regarding statute, or by invalidating statutes, in whole or in part, where they serve only private interests at the expense of the public, the judiciary will decrease the durability of legislative bargains and thereby make investment in rent-seeking less attractive. Raising the costs of rent-seeking would serve the public interest by reducing the level of wealth transfers and other welfare-reducing misallocations of resources.

## II. PUBLIC CHOICE, DURABILITY, AND SIMULTANEITY OF PERFORMANCE

The theory of public choice, also known as the economic theory of legislation, makes the same basic assumptions about self-interest for politicians and bureaucrats that standard economic analysis makes for private sector actors. Thus, public choice theory views regulation as a commodity like any other. As Richard Posner has observed, "the interest group theory asserts that legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare."<sup>7</sup> According to the public choice theory of legislation, market forces provide strong incentives for self-interested politicians to enact laws that serve private rather than public interests because, over a wide range of issues, these private groups can provide politicians and bureaucrats with the political support they need to serve their objectives of achieving re-election, or of maximizing their bureaucratic turf. In a nutshell, public choice theory posits that laws and regulations are supplied by lawmakers and bureaucrats to the political groups or coalitions that outbid competing groups.

Public choice theory has attracted a wide variety of adherents among welfare state liberals and Marxists, as well as among free-market economists. In general there has been a "shift in scholarly

<sup>7</sup> Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U Chi L Rev 263, 265 (1982).

thinking about legislation from a rather naive faith in the public-interest character of most legislation to a more realistic understanding of the importance of interest groups in the legislative process."<sup>8</sup> The widespread acceptance of public choice theory is linked to increasing suspicion about much of what Congress does.

The public choice literature has attempted to specify more precisely the process by which organized special interest groups obtain rules that transfer wealth from weaker political coalitions to themselves. Concentrated interest groups demand special benefits for themselves. Individual citizens and less organized groups supply this legislation by paying the taxes and incurring the costs of complying with the regulations that transfer wealth to such groups. Politicians act as brokers between these two groups and as entrepreneurs. The politicians' goal is to maximize their own political support, most obviously by passing legislation designed to appeal to particular groups. The politicians, however, can also use more creative tools. They can, for example, define issues around which newly formed groups can coalesce, and they can devise laws that overcome the organizational obstacles of high information costs and transaction costs (such as free rider problems) among interest group members that plague wealth-transfer seeking interest groups.<sup>9</sup>

While interest groups compete in a political marketplace, legislative institutions behave like private-sector firms whose output is law. As such, the theory of the firm, rather than the theory of market exchange, guides the public choice analysis of legislative institutions such as Congress.<sup>10</sup> Like all firms, Congress organizes its internal affairs to minimize the costs of assuring contractual performance.

Perhaps the most acute bargaining problems facing politicians are those arising from non-simultaneity of performance. Politicians generally will attempt to obtain political support from interest groups before an election, but will not be able to "pay for" this political support by supporting legislation favored by the interest group until after the election. Interest groups therefore have reason to worry that politicians will renege on their promises of support. Conversely, incumbent politicians often will be called upon to provide political support for a particular bill favored by an interest group in exchange for a promise of future support by the interest group.

<sup>8</sup> Richard A. Posner, *The Federal Courts: Crisis and Reform* 271 (Harvard, 1985); see also Joseph P. Kalt and Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 *Am Econ Rev* 279 (1984).

<sup>9</sup> Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 *Cornell L Rev* 43 (1988) ["Macey, *Public Choice*"].

<sup>10</sup> See Ronald H. Coase, *The Nature of the Firm*, 4 *Economica* 386, 394 (1937).

Politicians therefore have reason to worry that the groups will renege on their promises.

The most serious simultaneity of performance problem results from the fact that, even after an interest group has succeeded in achieving enactment of a particular statute, there can be no promise that future legislators will not renege on the previously agreed upon legislative deal, particularly if the original configuration of interest groups loses power.

Much of the "industrial organization" of Congress is designed to deal with this simultaneity of performance problem. Congress has a strong incentive to resolve this problem because it would otherwise be difficult for Congress to make a credible commitment to an interest group that a particular legislative scheme will have the crucial characteristic of durability. More durable statutes and regulations will be worth more to politicians than less durable statutes and regulations because interests groups are willing to pay for durability.

The basic way that Congress and regulators deal with this non-simultaneity of performance problem is by making it difficult to pass legislation in the first place. The more difficult it is to pass legislation, the more difficult it will be to repeal legislation. In addition, the committee system was arguably developed in order to concentrate legislative power in the hands of a small number of people who would be closely linked to the interest groups associated with particular legislation. Thus, congressmen from farm states (and, more recently, from districts heavily populated by food stamp recipients) are disproportionately represented on the agricultural committees in Congress. This, in turn, means that as long as the farm lobby controls the congressmen from the farm states and the natural alliance between farmers and food stamp recipients holds, these interests will be able to block the introduction of legislation adverse to them.

These types of rules permit congressmen to make credible commitments to interest groups that laws passed now will survive in future legislative sessions. Similarly, the bicameral legislature, executive veto, and independent judiciary all address this non-simultaneity of performance problem by moving the voting rules for passing new laws closer to a unanimity requirement, thus making laws difficult to modify once enacted.<sup>11</sup>

Politicians can also establish administrative agencies to make legislation more durable. Administrative agencies make legislation

<sup>11</sup> James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (U Mich, 1966).

durable by creating a stable of professional bureaucrats whose own futures are inextricably linked to the maintenance of a particular regulatory regime. Thus, for example, the securities laws and the banking laws benefit certain industry participants both by creating barriers to new entry, and by creating other rigidities favorable to incumbents. These laws also created significant bureaucratic structures that have made reform and repeal of these laws surprisingly difficult.

The preferences of the majority of voters are virtually irrelevant in determining legislative outcomes when viewed within the public choice framework. Instead, law is made by legislators whose primary goal is to aggregate the political support they receive from competing special interest group coalitions, and legal rules are generated by a process that conforms to standard microeconomic models of rationally self-interested behavior.

Political scientists have used the terms "coalitional drift" and "bureaucratic drift" to describe with more precision how non-simultaneity of performance problems between politicians and interest groups can arise. Bureaucratic drift describes the problem where the high costs of monitoring and controlling bureaucracies leads to situations in which bureaucrats will act in ways inconsistent with the original deal or "coalitional arrangement" struck between interest groups and politicians.<sup>12</sup> Coalitional drift describes the contracting problem caused by fluctuations in the preferences of the electorate and shifts in the preferences of politicians. The problem of coalitional drift manifests itself when Congress wishes to undo deals struck between interest groups and prior legislatures.<sup>13</sup>

Generally speaking, the cure for bureaucratic drift is ex post control over bureaucratic behavior by congressional subcommittees, oversight by specialized agencies such as the Congressional Budget Office and the General Accounting Office, and reliance on interest group notification. This oversight is supplemented by legal requirements that agencies provide information about themselves to their political watchdogs.<sup>14</sup> Similarly, micro rules (like the prohibition on ex parte communication that enables politicians, but not interest groups, to gain direct one-way access to administrators) and macro rules (like congressional control over agency funding) permit politi-

<sup>12</sup> McCubbins, Noll & Weingast, *Administrative Procedures* at 255 (cited in note 2).

<sup>13</sup> Murray J. Horn and Kenneth A. Shepsle, *Commentary on "Administrative Arrangements and the Political Control of Agencies,"* 75 Va L Rev 499 (1989).

<sup>14</sup> Macey, *Organizational Design* at 95 (cited in note 3).

cians to control bureaucratic drift.<sup>15</sup> The bottom line is that Congress and interest groups structure the administrative process in order to permit interest groups to preserve the benefits of the prior deals they have struck in the face of recalcitrant bureaucrats. The lesson of bureaucratic drift is that when bureaucrats misbehave, Congress has the ability to respond in a wide variety of ways.

But what happens when Congress lacks the will to respond? This is the problem of coalitional drift, which describes what happens when Congress's own preferences change. The danger to legislator-interest group dealmaking that this will occur is much more serious than the danger that Congress will be willing, but unable, to control behavior by bureaucrats that they find undesirable. As Shepsle has observed, over some range of administrative outcomes, efforts to control bureaucratic drift by empowering Congress to micro-manage agencies will exacerbate the problem of coalitional drift. The more that Congress and congressional staff are free to interject themselves in the bureaucratic decision process, the smaller the problem of bureaucratic drift, but the greater the problem of coalitional drift. The more independent the administrative agency, the smaller the problem of coalitional drift, but the greater the problem of bureaucratic drift.<sup>16</sup>

To some extent, both of these problems can be ameliorated simultaneously by structural decisions about the administrative agencies themselves. Initial agency structure and design can reduce coalitional drift and bureaucratic drift simultaneously by ensuring that particular interest groups will receive the funding needed to remain strong, thereby enabling such coalitions to maintain their control over Congress, thus preventing coalitional drift. Initial agency design can likewise prevent bureaucratic drift by creating a specialized bureaucratic structure in which bureaucrats have a single clientele—like the savings and loan industry. This, in turn, creates a situation in which bureaucratic drift is unlikely since interest groups will capture the administrative agency, fill it with their own nominees, and then run it as a personal fiefdom. This not only helps ensure the fidelity of the administrative agency, but also the longevity and continued vitality of the interest group as well.

Of course, this happy outcome (from the interest group's perspective) is not inevitable. Where, as in the savings and loan situation, the perverse incentives created by a particular regulatory structure

<sup>15</sup> McCubbins, Noll & Weingast, *Administrative Procedures* (cited in note 2).

<sup>16</sup> Shepsle, *Bureaucratic Drift* (cited in note 5).



are simply overwhelming, the system can collapse under its own weight, ruining both the agency and the industry it was designed to protect. The story of the savings and loan industry and its capture of the thrift regulators represents a textbook case of the way Congress can exert *ex ante* control over the outcomes generated by an administrative agency. Congress accomplishes this by controlling the ability of other outside groups to exert political pressure on the agency and by reducing the incentive of other groups to form opposition to the agency's behavior.

Congress did not have to create a single regulator for the thrift industry. It could have consolidated thrift regulation with banking regulation generally. In creating a single-interest-group agency, Congress ensured the capture of the agency by the group. By contrast, where the original legislative enactment involves an administrative agency which allows access to a broad cross-section of groups, capture by a single group is much less likely. Thus, the creation of single-interest administrative agencies is one mechanism legislators use to promote deals that have a significant degree of durability.

### III. THE SAVINGS & LOAN CRISIS

The background leading up to the *Winstar* case is relatively simple. Interest groups gained virtually complete control over an administrative agency, the Federal Home Loan Bank Board. This dominance manifested itself in the creation of a regulatory environment that first permitted, and then rewarded, risk-taking by operators of federally insured savings and loan institutions. In particular, the flat-rate deposit insurance scheme existing until 1991 did not include risk-adjusted premiums, thereby creating acute moral hazard. Shareholders of savings and loan associations had strong incentives to invest in high-risk, high-return projects. In the rare cases when such projects turned out well, the shareholders would reap the rewards. When the projects failed, the Federal Savings and Loan Insurance Corporation (FSLIC), and then, after the insolvency of the FSLIC, the U.S. taxpayer, absorbed the vast majority of the losses. Later, the large, uninsured but politically sophisticated depositors in these insolvent savings and loan institutions convinced the thrift regulators to refrain from closing failed S&Ls. The FSLIC bailed out virtually all of the creditors of failed S&Ls by merging the assets and deposits with other institutions.

These deals were structured to involve virtually no risk to acquiring institutions. First, many mergers gave acquirors "put options" in the form of promises by regulators that required the FSLIC to

repurchase assets (loans) acquired in mergers if those assets later went into default.<sup>17</sup> For other assets, the FSLIC guaranteed a certain rate of return to the acquiror under so-called "yield maintenance" agreements. These agreements assured acquirors a substantial rate of return on any assets not resold to the FSLIC.<sup>18</sup>

In other words, the deals made between the FSLIC and acquirors of failed thrifts generally were structured to involve no risk to the acquiror. Worse, the deals were structured so as to minimize current outlays by the FSLIC, but to impose massive future contingent liabilities on the agency. These massive future liabilities ultimately bankrupted and then destroyed the FSLIC: the agency was eliminated and its insurance function was transferred to the Federal Deposit Insurance Corporation. For years, Congress "acquiesced to FSLIC policies in return for political support from S&Ls across the West and Southwest."<sup>19</sup>

From a political perspective, Congress's initial organizational design of the bureaucratic infrastructure of the S&L industry was hugely successful. Even after the industry was bankrupt, its faithful bureaucracy continued slavishly to serve its interests. The regulators protected all industry participants—operators of failed thrifts, creditors of failed thrifts and acquirors of failed thrifts—at a huge ultimate cost to the general public. One wonders what the role of the independent federal judiciary was—or should have been—in all of this. One answer to that puzzle emerged in the *Winstar* case.

#### IV. WINSTAR

One of the more creative devices employed by thrift regulators involved incentives given to thrifts acquiring other, failed thrifts at the height of the S&L crisis. The situation addressed in *Winstar* was caused by a dramatic case of the sort of coalition drift described above. The coalition drift came from two sources. First, the collapse of the S&L industry itself by definition sapped the industry of resources, and thereby reduced the industry's ability to lobby Congress. Second, and more important, the huge costs of the S&L bailout to taxpayers, coupled with several high-profile scandals involving thrift institutions (investigations of the "Keating Five" senators and

<sup>17</sup> Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 Duke L J 469, 539-40 n 256 (1992).

<sup>18</sup> FDIC Policy Eases GAO Concerns About Review of 1988 FSLIC Deals, 55 BNA Banking Rep 149 (1990).

<sup>19</sup> Jonathan R. Macey, *Savings & Loan Regulations Create "Win-Win" Situation for Risk-Takers*, LA Times M3 (Feb 5, 1989).

the resignations of Congressman Tony Coehlo and House Speaker Jim Wright all were related to thrift industry scandals), transformed the former backwater of S&L regulation into a highly salient political issue.

This, in turn, led to the dismantling of the pre-existing regulatory infrastructure that previously had governed the thrift industry. In its place, Congress passed new regulations that greatly reduced the discretion of regulators to transfer wealth from taxpayers to bankers. In particular, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to respond to many of the failed regulatory strategies that led to the thrift crisis. FDICIA reflects a "renewed focus on responsibility and discipline" in the finance of U.S. depository institutions by reducing the discretion of regulators, imposing market discipline in the bank failure context, and ameliorating the moral hazard problems that plague bank equity claimants.<sup>20</sup>

As noted above, regulators protected thrift operators by responding to insolvencies in a dilatory manner. Thrift regulators avoided "prompt corrective action"—i.e. the prompt closing of insolvent and near-insolvent insured financial institutions—despite the fact that early closure would have produced substantial savings for both the FSLIC insurance fund and taxpayers. These savings would have resulted from prompt action because it would have prevented both the deterioration of the value of thrift assets and an increase in the amount of thrift liabilities during the period immediately preceding regulatory intervention.

The moral hazard facing bank equity claimants causes assets to decline in value and liabilities to increase in value as insolvency approaches. This is because shareholders of insured depository institutions have incentives to take risks as their equity position deteriorates: losses will be disproportionately borne by the debt-holders (including the FSLIC) while gains will accrue to the shareholders. As Robert Litan and Jonathan Rauch observe, FDICIA

requires regulators to impose progressively sterner sanctions if the capital ratios of the institutions they supervise fall below the mandated minimum. Significantly, regulators are authorized (by FDICIA) to seize control of a weakened bank or thrift even before it is economically insolvent. . . . These "prompt corrective actions" reverse the failed policy of "regulatory forbearance" practiced in the 1980s and send a powerful signal to the owners

<sup>20</sup> Robert E. Litan and Jonathan Rauch, *American Finance for the 21st Century* 27-31 [US Dept of the Treasury, 1997].

of banks and thrifts that they will pay a price if they extend their risk-taking further than their capital safely will allow.<sup>21</sup>

FDICIA also addressed the moral hazard problem facing thrift equity claimants by requiring the FDIC (the successor agency to the FSLIC) to charge insured depository institutions insurance premiums that are linked to the riskiness of the institutions. This provides insured depository institutions for the first time in regulatory history with an incentive to refrain from excessive risk-taking. Prior to FDICIA, the flat-rate insurance premiums paid by thrifts permitted thrift operators to transfer wealth from the federal insurer (and thus the taxpaying public) to themselves by increasing bank riskiness (volatility).<sup>22</sup>

Putting aside the issue of agency capture, another problem with the way that depository institution failures were resolved prior to FDICIA was that the law did not take account of the fact that thrift regulators themselves had strong bureaucratic incentives to delay recognition of bank failures, even in the absence of political pressure by politicians and interest groups. This is because regulators' performance is evaluated by the press and congressional oversight committees in ways that impose perverse incentives on regulators. Specifically, regulators are evaluated on the basis of their ability to maintain the dollar balance of the insurance fund for which they are responsible during their tenures in office.<sup>23</sup> And regulatory performance is similarly evaluated by comparing the raw number of bank or thrift failures during one regulator's administration with the number of failures during prior periods. Both measures create incentives for regulators to deny the severity of problems in the institutions they regulate and to avoid prompt corrective action: criticism comes when there is an increase in the number of failed banks and when payouts reduce the balance in the insurance fund.

FDICIA sought a general and long-term solution to the structural problems brought to light by the S&L crisis. The first steps in this direction had been taken by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), which made major changes in the regulation of the banking industry in general and thrift institutions in particular. FIRREA abolished the FSLIC and transferred its functions to other agencies. FIRREA also created a new thrift deposit insurance fund under the supervision of the FDIC

<sup>21</sup> Id at 30.

<sup>22</sup> Jonathan R. Macey and Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 Colum L Rev 1153 (1988).

<sup>23</sup> Jonathan R. Macey and Geoffrey P. Miller, *Banking Law and Regulation* 280-83 (Little, Brown, 2d ed 1997) ("Macey & Miller, *Banking Law*").

and replaced the primary thrift regulator, the Federal Home Loan Bank Board, with the Office of Thrift Supervision, a Treasury Department office with responsibility for the regulation of all federally insured savings associations. And FIRREA created the Resolution Trust Corporation which had responsibility for liquidating or otherwise disposing of the assets of closed thrifts.

FIRREA gave rise to the underlying cause of action in the *Winstar* case by obligating the newly created Office of Thrift Supervision (OTS) to "prescribe and maintain uniformly applicable capital standards for savings associations" in accord with strict statutory requirements. Specifically, the statute required thrifts to "maintain core capital in an amount not less than 3 percent of the savings association's total assets"<sup>24</sup> and defined core capital specifically so as to exclude "unidentifiable intangible assets" such as good will.<sup>25</sup> As the legislative history of FIRREA made clear, these provisions responded directly to the fact that "[t]o a considerable extent, the size of the thrift crisis resulted from the utilization of capital gimmicks that masked the inadequate capitalization of thrifts."<sup>26</sup>

FIRREA responded to the lawless and corrupt accounting practices utilized by thrift regulators under the auspices of the Federal Home Loan Bank Board. The requirement that a federally insured depository institution retain adequate capital is one of the few and perhaps "the most powerful source of (market) discipline for financial institutions."<sup>27</sup> Capital requirements are an important source of market discipline for banks because it reduces shareholders' moral hazard by requiring shareholders to bear some of the consequence of risky activities (along with fixed claimants such as the FSLIC or the FDIC). At the limit, when a firm receives all of its funding in the form of capital (equity) and has no debt, there is no moral hazard problem at all, since the shareholders fully internalize all losses to the firm. At the other limit, when a firm is funded with all debt and no (or virtually no) equity, the moral hazard problem is ubiquitous: fixed claimants (i.e. the government in its capacity as guarantor of deposits) bear all of the losses, while the equity claimants reap any and all of the gains that might accrue from risky ventures. This is the state of affairs that characterized the bank mergers condoned by thrift regulators prior to the passage of FIRREA.

<sup>24</sup> 12 USC § 1464(t)(2)(A) (1994).

<sup>25</sup> 12 USC § 1464(t)(9)(A) (1994).

<sup>26</sup> HR Rep No 101-54(I), 101st Cong, 1st Sess 310 (1989), reprinted in 1989 USCCAN 86, 106.

<sup>27</sup> Richard C. Breeden, *Thumbs on the Scale: The Role that Accounting Practices Played in the Savings and Loan Crisis*, 59 Fordham L Rev 571, 575 (1991).

Narrowly construed, the *Winstar* case addresses the issue of whether the government's agreement to offer favorable (and fictional) accounting treatment to the capital created by a merger consummated under the auspices of government regulators is legally enforceable. If the promises made in these shady government deals are legally enforceable, then the government is liable for damages when Congress abrogates these agreements, as it did in FIRREA. In *Winstar*, the Supreme Court held that the government is liable for damages, but left open the vitally important question of how such damages are to be calculated. Damages estimates range in the billions of dollars.

This case provides an important historical account of the FSLIC's handling (or mishandling) of the savings and loan crisis. The shift to "regulatory accounting principles" (RAP), as distinct from "generally accepted accounting principles" (GAAP) was a major part of FSLIC's strategy to avoid or put off the day of reckoning for the fact that a large portion of the thrift industry, and the FSLIC fund itself, was deeply under water.

The case turns on accounting principles that, while somewhat arcane, warrant some attention. The government's approach involved a manipulation of the standard accounting technique used in mergers. This standard accounting approach, well recognized and perfectly legitimate under GAAP, is called the "purchase method" of accounting. The purchase method of accounting works as follows. Suppose a Savings & Loan has the following (radically simplified) balance sheet:

Assets	Liabilities and Net Worth
\$100 tangible assets	\$75 debt
	\$25 net worth

At any particular point in time, this balance sheet may not accurately reflect the true value of the firm, because the dollar value for the assets on the balance sheet will be entered at their historical acquisition cost and then adjusted (amortized and depreciated) under a set of assumptions that may not reflect changes in their actual value over time. For example, in the case of real estate, it might be the case that the assets are worth more than historical cost accounting reflects because the real estate market has performed well.

Suppose that this hypothetical thrift institution is acquired in a merger for \$50, despite the fact that the book value of the thrift's assets is only \$25. While it is possible that the buyer has overpaid, such an outcome is unlikely in an arms-length transaction between

two sophisticated parties. More likely, the buyer has paid above book value because the assets are worth more than the historical accounting value (\$100) shown on the books.

The purchase method of accounting commonly used in mergers provides opportunities for acquirors to present a more realistic picture of the post-acquisition value of their firm by allowing such acquirors to record the excess price that they have paid over book value as a new asset, "goodwill." Under purchase method accounting, the value of the thrift institution's balance sheet following the merger looks like this:

Assets	Liabilities and Net Worth
\$100 tangible assets	\$75 debt
\$25 good will	\$50 net worth

Absent this accounting treatment, it would appear as though the acquiror had overpaid for this thrift institution. Purchase method accounting permits acquirors to adjust the balance sheets of the thrift institutions they acquire in order to make them reflect the true, market value of the firms they acquire.

However, goodwill is like other assets in that its value can change over time. In particular, because goodwill reflects (in addition to increases in the value of tangible assets) such intangible items as the value of employee morale, the quality of its workforce, the benefit of a favorable reputation, etc., the value of these items will deteriorate in value over time unless the firm expends resources to maintain them. Consequently, good accounting practice requires that the value of goodwill be amortized—written down—over some period of time.

The regulatory accounting principles used in FSLIC assisted mergers were essentially a bastardized form of purchase value accounting. The FSLIC's approach, which was designed to move troubled thrifts into the hands of (often politically well-connected) acquirors at the lowest possible price, deviated substantially from GAAP accounting. In particular, in using the purchase method of accounting in accordance with GAAP, the recognition of goodwill as an asset makes sense because "a rational purchaser in a free market, after all, would not pay a price for a business in excess of the value of that business's assets unless there actually were some intangible 'going concern' value that made up the difference."<sup>28</sup>

<sup>28</sup> *United States v Winstar*, 116 S Ct 2432, 2442 (1996) (citing Martin Lowy, *High Rollers—Inside the Savings and Loan Debacle* 39 (Praeger, 1991)).

By contrast, in the deals engineered by the thrift regulators, there was in reality no asset that could be called goodwill. The present market value of the assets of these thrifts was lower, considerably lower, than the present value of their liabilities. That is why they were insolvent. These assisted mergers were transactions in which a solvent institution would acquire an insolvent savings and loan in so-called "purchase and assumption transactions" in which the solvent institution was supposed to acquire the assets and assume the liabilities of the troubled institution. Where the value of the liabilities is greater than the value of the assets, no willing acquiror will come forward to make the acquisition unless somebody is willing to make up the difference between the value of the liabilities and the value of the assets.

Because the FSLIC lacked the political will to close these insolvent institutions, it used accounting gimmicks and regulatory forbearance to induce healthy firms to acquire sick thrifts. This favorable accounting treatment substantially reduced the amounts FSLIC needed to pay the acquiring firms to make thrift acquisitions. In essence, these transactions were fraudulent because they allowed acquiring financial institutions to create a fictional asset (interestingly called "supervisory goodwill": these acquirors certainly enjoyed the goodwill of their regulatory supervisors), and to record this "asset" on its balance sheet. This fictional accounting served a number of purposes. First, thrift regulators let these acquiring institutions count this "supervisory goodwill" toward their reserve requirements, thereby allowing acquirors to increase their leverage, making more and more loans on less and less capital, thereby dramatically increasing the loss exposure to the government sponsored FSLIC insurance fund. More important, this accounting treatment was necessary to make these acquisition transactions possible in the first place: absent the accounting gimmicks, the financial institutions created as a result of these mergers would have been insolvent immediately because of their lack of capitalization.

The favorable accounting treatment manifested itself in other ways besides allowing the "supervisory goodwill" of an assisted merger to be counted towards the institution's regulatory capital (on the right side of the balance sheet), thereby allowing the institution to make more loans under the capital adequacy guidelines. Even more important was the fact that the FSLIC allowed the acquiring firm to write down (amortize) the value of this fictitious "goodwill" at a much slower pace than is generally permissible.<sup>29</sup>

<sup>29</sup> *Winstar*, 116 S Ct at 2443-46.



Specifically, acquiring thrifts were permitted to write down the value of this good will at a slower pace than they were writing up the value of their loans. These loans, it should be noted, were worth much less than face value because they paid low interest, but were increasing in value because they were approaching maturity. And as they approached maturity, a lower percentage of their total value consisted of interest payments and a higher percentage of their total value consisted of the value of the principle repayment owed at maturity. As noted by the *Winstar* Court, these two items—the increase in value of the loan portfolio and the decrease in value of the supervisory goodwill—almost exactly offset each other as an economic matter; but from an accounting standpoint, the faster rate of increase in loan portfolio value meant that the acquiring institution could show a substantial paper profit during the early years (although it would have to pay the piper later on).<sup>30</sup> Finally, FSLIC allowed acquiring firms to double count the amount of FSLIC's cash contribution, thus artificially increasing both assets and net worth.<sup>31</sup>

It is important to understand the consequences of these accounting gimmicks. First, they allowed the thrift regulators to disguise the true dimensions of the thrift problems. Second, by postponing the ultimate resolution of these insolvent thrifts, the thrift regulators greatly increased the final resolution costs as losses continued to mount. Third, by creating a whole new set of merged financial institutions with little or no real capital, the thrift regulators also compounded the costs of the thrift bailout by increasing the already high level of moral hazard within the industry. And, finally, these transactions transferred considerable wealth from a highly disaggregated group—the U.S. taxpayers, who were the ultimate guarantors of the FSLIC insurance fund—to the highly concentrated and politically well-connected creditors and acquirors of failed thrifts.

Acquiring firms were not so naïve as to ignore the controversial, indeed lawless, nature of these transactions. As early as 1983, the Financial Accounting Standards Board, which is the group responsible for promulgating GAPP, had issued Statement of Financial Accounting Standards ("SFAS") 72 which applied specifically to the acquisitions of savings and loan associations.<sup>32</sup> This Statement made it absolutely clear that not only was the creation of "supervisory goodwill" out of whole cloth inconsistent with generally accepted accounting principles, but also that the differential amortization

<sup>30</sup> Id at 2444.

<sup>31</sup> Id at 2444-45.

<sup>32</sup> Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 72* (Fin Accounting Stds Bd, 1983).

periods for goodwill<sup>33</sup> and the double accounting of capital<sup>34</sup> were inconsistent with standard accounting procedures.

Certainly before, but without a doubt after, the promulgation of these accounting rules, specifically addressed to the accounting treatment of the acquisition of insolvent thrifts in mergers receiving the assistance of regulatory agencies, acquirors knew that there was something very wrong with the regulatory treatment of these mergers. In particular, acquirors well understood that there were political risks associated with these deals. Accordingly, acquirors demanded and received the government's contractual promise to give them this favorable accounting treatment.

By 1989, however, the political climate was much different. The public was outraged by the scandals and above all by the huge and mounting costs imposed on them by the mishandling of the thrift industry. Congress was highly sensitive to charges of political favoritism and cronyism on the part of politicians and regulators towards shady thrift operators. Congress viewed the use of "regulatory accounting" as an important part of the overall pattern of fraud and mismanagement that created the savings and loan crisis in the first place. When Congress withdrew the favorable accounting treatment by passing FIRREA, it had an immediate and grave impact on a large number of thrifts. With the elimination of this bogus accounting treatment, these thrifts were suddenly moved from a position of solvency to a position of non-compliance with regulatory capital standards. And FIRREA demanded that insolvent financial institutions be closed promptly unless they could be recapitalized through the injection of substantial amounts of new equity.

## V. WINSTAR AND THE ROLE OF THE U.S. SUPREME COURT IN PROTECTING INTEREST-GROUP DEALS

FIRREA caused failure or grave damage to a substantial number of thrift operators who had acquired failing savings and loans in supervisory mergers during the previous decade. In *Winstar*, the

<sup>33</sup> SFAS 72 provides that "if and to the extent that, the fair value of liabilities assumed exceeds the fair value of identifiable assets acquired in the acquisition of a banking or thrift institution, the unidentifiable intangible assets *shall be amortized to expense by the interest method over a period of time no longer than the discount on the long-term interest-bearing assets acquired. . .*"

<sup>34</sup> SFAS 72, paragraph 9 requires that financial assistance from regulatory authorities must be deducted from the cost of the acquisition before the amount of goodwill is determined.

Supreme Court resolved one key element of the dispute over those losses: the government is liable for reneging on the promises made by thrift regulators to thrift operators. The Court remanded to the lower courts the next phase of the dispute, determination of the amount of the government's liability in the many pending cases. The amount of the government's exposure is presently unknown, but certainly will run into the billions of dollars.

In *Winstar*, the Court repeatedly emphasized the fact that the agreements between failed thrifts and the regulators were contractual in nature, and that these accounting gimmicks were a *sine qua non* for the mergers:

[W]e have no doubt that the parties intended to settle regulatory treatment of these transactions as a condition of their agreement. We accordingly have no reason to question the Court of Appeals's conclusion that "the government had an express contractual obligation to permit [Glendale Federal Bank, FSB, one of the thrifts involved in the consolidated *Winstar* litigation] to count the supervisory goodwill generated as a result of its merger with Broward as a capital asset for regulatory capital purposes."<sup>35</sup>

The *Winstar* case has often been characterized as involving the simple issues of whether there were contractual relationships between thrift operators and the government, and whether the government should be liable for the consequences of its failure to perform its contractual promises. This is not true. The more interesting issue in the case was who was contractually obligated under these agreements to bear the risks of loss associated with subsequent changes in regulation, not whether contractual relationships existed between thrift operators and government regulators.

Nothing in the contracts between these thrifts and the government purported to bar the government from changing the way the thrift industry was regulated.<sup>36</sup> That is why there was an issue as to who was required to bear the risk of loss from such a change. The plurality opinion relegated to a footnote the critical fact that the agreements were ambiguous with respect to this vital issue.<sup>37</sup> As the Court noted in this footnote, in light of the size and importance of these transactions, such ambiguity was "surprising."

The government relied heavily on the principle that contracts limiting the government's future exercises of regulatory authority

<sup>35</sup> *Winstar*, 116 S Ct at 2449-50 (citations omitted).

<sup>36</sup> *Id* at 2452.

<sup>37</sup> *Id* at 2452 n 15.

are strongly disfavored.<sup>38</sup> The Court dismissed this argument on the ground that the contracts between the thrift regulators and the thrift operators did not limit the government's ability to exercise its regulatory authority since the government could modify its regulations, subject, of course, to liability for damages for any breach of contract involved in such a modification.<sup>39</sup>

This analysis camouflages a couple of key points. First, raising the costs of something, especially by billions of dollars, reasonably will be expected to curtail the supply. Thus, raising the cost of enacting a statute like FIRREA by billions of dollars reasonably will be expected to curtail the supply of such statutes. And, as suggested above, FIRREA was not an ordinary statute. It was designed to root out mismanagement and corruption. The statute accomplished this not only by eliminating these accounting gimmicks, but also by eliminating the agencies responsible for the problem in the first place.

The Court defends its decision by saying that it was protecting the "Government's own long-run interest as a reliable contracting partner in the myriad workaday transaction of its agencies."<sup>40</sup> While this analysis is certainly accurate as far as it goes, it does not go very far in this context. As explained below, the statement that the *Winstar* decision protected the government's reputation as a reliable contracting party was accurate in ways probably not contemplated by the Court. But to claim that these extraordinary contracts between the thrifts and the thrift regulators were ordinary and could therefore be compared with a government procurement contract or a contract to sell federal property is a real stretch. The very purpose of the capital requirements in place before FIRREA (and strengthened in the legislation itself) was to make thrift operators bear the consequences of their risky activities. The *Winstar* decision undermined Congress' ability to accomplish this legitimate statutory purpose.

Moreover, a strong argument can be made that the FSLIC lacked the authority to make the deals it made. First, the FSLIC had the authority to guarantee an insured institution against losses realized in mergers and in asset purchases with other institutions.<sup>41</sup> But there was no statutory grant of authority permitting regulators to *fail to recognize* such losses in the first place through accounting gimmickry. Similarly, while the FSLIC was authorized to permit thrifts to count goodwill (and subordinated debt) to meet regulatory capital

<sup>38</sup> Id at 2453.

<sup>39</sup> Id at 2458-59.

<sup>40</sup> Id at 2459.

<sup>41</sup> 12 USC § 1729(f)(2)(A)(iii) (1988) (repealed 1989).

and reserve requirements,<sup>42</sup> nothing permitted the FSLIC arbitrarily to change the meaning of these precise, technical terms.

Indeed, the use of these terms in the statute suggests that Congress meant for them to be construed by the regulators with some fidelity to their generally understood meanings. Similarly, the regulations permitting the Bank Board to determine the capital levels to be required of FSLIC insured institutions suggests that Congress expected that these institutions would indeed be required to have some capital.<sup>43</sup>

In other words, the decision in *Winstar* provided constitutional-level protection for highly suspect deals made by highly politicized bureaucrats in concert with well-connected bankers. The bankers received what they sought—bargains and regulatory loopholes. The bureaucrats received political support, and they were able to avoid having the true dimensions of the thrift debacle recognized on their watches, by delaying and denying the true size of the losses.

There is little doubt that the contracts between the Bank Board and thrift operators, such as those involved in *Winstar*, were not consistent with the public interest. These agreements, as outlined above, aggravated the decline of the thrift industry by dramatically increasing the levels of moral hazard and financial risk (leverage) in an already fragile and over-regulated industry. FDICIA, by contrast, addressed the causes of the thrift debacle, and, along with FIRREA represented a bold decision to restore public confidence in the banking industry in general and the system of bank regulation in particular. But these statutes also deprived the thrift industry of the benefits of the deals they had struck with regulators.

The *Winstar* decision provides an important window on the mechanics of the dynamic relationship between Congress, administrative agencies, and the federal judiciary. An earlier Congress had created a regulatory structure in which the (once) powerful thrift industry was provided with a malleable and corruptible agency ripe for capture. As I noted in another context, "long after there was any economic need for a savings and loan industry, thrift regulators took extraordinary steps to ensure the industry's survival. The regulators acted as they did, not to further the public interest, but because they understood that the survival of the industry was crucial to their own professional survival."<sup>44</sup> The actions of the thrift regulators in codling the interests of the industry at the expense of the public, while

<sup>42</sup> 12 USC § 1730h(d) (1988) (repealed 1989).

<sup>43</sup> S Rep No 100-19, 100th Cong, 1st Sess 55 (1987), reprinted in 1987 USCCAN 489, 545.

<sup>44</sup> Macey, *Organizational Design* at 97 (cited in note 3).

extreme, were consistent with the cozy regulatory structure of the thrift industry, which was organized so as to permit the industry to manipulate the regulatory structure to achieve desired outcomes.

At the outset of this article, I identified three ways that the contracting problems between interest groups and politicians are likely to manifest themselves. *Winstar* shows how the contracting parties can craft legislation to mitigate these problems.

The first problem is a simple monitoring problem. The principals (politicians) cannot monitor thrift regulators costlessly. There were substantial direct monitoring costs, and even more substantial indirect costs in the form of political risk from constituents who would be outraged at the behavior of politicians such as the senators known as the "Keating Five," who tried to obtain regulatory forbearance from the thrift regulators on behalf of large contributors. To a very large extent, the thrift industry solved this problem by creating a captured regulatory agency whose allegiance to the industry was strong and unchallenged by rivals. The Depression-era Congress that created this cozy regulatory environment captured all of the initial rents from the promulgation of this law.

In addition to the agency cost issue described above, there is the similar problem of bureaucratic drift. Bureaucratic drift describes the risk that an interest group might not be able to retain control of an agency once it is created. But, in the context of the thrift industry, we see that the very design of the agency itself tied it to its constituency. Because the thrift regulators had responsibility for a single industry, their fate was tied to the fate of that industry. This structure all but ensured the capture of the agency by the industry, which, of course, is exactly what happened.

Finally, of course, when the thrift industry obtained its cozy regulatory structure back in 1933, there was the danger that a subsequent Congress might change its mind and undo some of the cozy arrangements put into place by the bureaucrats. And, of course, this is exactly what FIRREA and FDICIA accomplished in the thrift industry. The entire corrupt regulatory infrastructure was dismantled as the costs of the thrift bail-out both weakened the lobbying power of the thrift operators, and made the savings and loan industry a salient political issue for the first time in its history.

Because of these features, *Winstar* provides an excellent forum for testing the highly controversial Landes and Posner thesis about the role of an independent judiciary in the rent-seeking context.<sup>45</sup>

<sup>45</sup> William M. Landes and Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J L & Econ 875 (1975).

The Landes and Posner thesis is that an independent judiciary, such as the one that exists in the United States (where judges enjoy constitutional protections such as life-time tenure and are otherwise insulated from the political process), also contributes to the resolution of the fundamental contracting problems that exist between interest groups and politicians by providing durability to statutes, thereby raising the value to interest groups of engaging in rent-seeking in the first place.

Under the Landes and Posner approach, the independent judiciary raises the value of rent-seeking by enforcing deals according to their original terms. As Landes and Posner see it, in the absence of a binding long-term contract, the enacting Congress cannot prevent a subsequent Congress from amending legislative interest-group deals in a way unfavorable to the winning coalition, or indeed from repealing it altogether. Both the enacting Congress and the interest group, however, incur substantial costs that "would not prove worthwhile if the legislation were to be altered unfavorably or repealed within a few months or years."<sup>46</sup> Thus, repealing or changing legislation by subsequent Congresses

would reduce the present value of legislative protection to interest groups in the future, and hence the enacting Congressmen's welfare. Such a manifestation of congressional bad faith would, by reducing the value of legislative protection to interest groups, impose costs on the faithless Congressmen: the "price" they could demand for enacting such legislation would be lower.<sup>47</sup>

Landes and Posner's point is that the stability and continuity necessary to enable interest-group politics to function is supplied in part by the existence of an independent judiciary. The independent judiciary supplies stability and continuity by interpreting and applying legislation in accordance with the original legislative understanding. This interpretive technique facilitates interest group politics by supplying the critical feature of durability to the deals struck between interest groups and legislatures.

It is, of course, clearly true that judges sometimes overturn or fail to enforce the legislative deals made between interest groups and legislatures. But this risk represents a cost of having an independent judiciary. Landes and Posner take the view that these costs are outweighed by the benefit (to the politicians and interest groups) sup-

<sup>46</sup> *Id.* at 877.

<sup>47</sup> *Id.* at 877-78.

plied by the deals that the judiciary protects against subsequent efforts at legislative encroachment. In other words, the costs associated with the occasional situations in which judicial independence results in over-turning some valued legislative deal are outweighed by the benefits of having a "system in which interest groups will have incentives to invest in legislation that yields them benefits over an extended period of time."<sup>48</sup>

*Winstar* at least partially supports the Landes and Posner analysis of the independent judiciary. In *Winstar*, there was a clear attempt by a legislature to renege on the terms of a prior legislative deal with the thrift industry. Although the Court permitted a subsequent Congress to alter the terms of the bargain with the interest group through the passage of FIRREA, it imposed a very heavy cost for doing so.

Moreover, the legislation that provided sustenance to the thrift industry was very old. Specifically, the Federal Home Loan Bank Act, which created the Federal Home Loan Bank Board, was enacted in 1932,<sup>49</sup> followed shortly thereafter by the Home Owners' Loan Act of 1933,<sup>50</sup> which authorized the Bank Board to charter and regulate federal savings and loan associations. In turn, these statutes were followed in 1934 by the National Housing Act, which created the FSLIC, the agency charged with insuring thrift deposits and regulating all federally insured thrifts.<sup>51</sup> The mere fact that this unwieldy and inefficient regulatory structure lasted for over half a century until the collapse of the thrift industry itself is testimony to the Landes and Posner durability thesis. Certainly, the durability of this legislation came from somewhere, and the presence of an independent judiciary clearly did no harm to the durability of the legislation.

Of course, the independent judiciary was not the only, or even the most important source of stability for the interest group bargains reflected in the thrift regulations described above. Two other sources of durability were more important. First, Congress has its own internal mechanisms for ensuring the stability of interest group bargains. These include bicameralism and the committee system, both of which make it difficult to change or repeal laws once they are made.

<sup>48</sup> Id at 879.

<sup>49</sup> Pub L No 72-304, 47 Stat 725 (1932), codified as amended at 12 USC §§ 1421-1449 (1988).

<sup>50</sup> Pub L No 73-43, 48 Stat 128 (1933), codified as amended at 12 USC §§ 1461-1470 (1988).

<sup>51</sup> Pub L No 73-479, 48 Stat 1246 (1934), codified as amended at 12 USC §§ 1701-1750g (1988).



Bicameralism (along with the availability of a presidential veto and other procedural devices such as the filibuster) raises the transaction costs of changing or repealing previously enacted laws in a straightforward way.

The committee system is an ingenious method for solving the problem of durability that confronts Congress. The committee system provides a way for congressmen to "forego influence in certain areas for additional influence in other areas, thereby increasing the aggregate demand for their services from the particular interest groups most influential in their home jurisdictions."<sup>52</sup> Legislators do not seek committee assignments randomly. They seek those assignments that are likely to have "the greatest marginal impact over their electoral fortunes."<sup>53</sup> Consequently, it is not surprising that there is a high correlation between the jurisdictions of particular committees and the levels of support shown by the committees' membership for the interest groups benefitted by the committee. Congressmen on particular committees, "[f]or a diversity of policy areas . . . are indeed significantly above-average supporters of benefits to the relevant interest group" affected by those committees.<sup>54</sup> In other words, the committee system allows committee members to specialize in the regulation of interest groups that are likely to provide them with the greatest political support. This, in turn, allows them to maximize the political support they receive from these groups. In the context of thrift regulation this meant that all the thrift industry had to do to keep its legislative program in place was to retain control of the congressional membership of the relevant congressional committees. Once this was done, those committees could keep legislation reforming the thrift industry from coming to a vote.

As noted above, in addition to the internal rules of Congress, the regulation of the thrift industry itself was structured so as to promote the longevity of the relevant legislation. The fact that the industry enjoyed its own regulator was significant. The industry was not competing with other banking and financial interests for the support of its regulators. And this single constituency structure all but assured that the agency, staffed with "experts" from within the industry itself (and whose futures lay within the industry), would be captured by the thrift operators it was purportedly regulating. The

<sup>52</sup> Macey, *Public Choice* at 55 (cited in note 9).

<sup>53</sup> Barry R. Weingast and William J. Marshall, *The Industrial Organization of Congress*, 96 J Pol Econ 132, 145 (1988).

<sup>54</sup> *Id.* at 151.

independent judiciary simply supplemented these other mechanisms for promoting the longevity of the thrift legislation.

## VI. CONCLUSION

The focus of this article is a positive analysis of the Court's behavior in *Winstar*, rather than a normative explanation of what it should have done. However, it is clear that an argument can be made that courts should be responsive to public choice concerns and ensure that legislation serves the public interest.<sup>55</sup> Courts ought to be sensitive to issues of administrative agency capture and try to respond by invalidating legislation and the bargains it entails when such capture is present. Short of invalidating special-interest legislation, courts can also use their tools to interpret statutes so that they serve as public-regarding instruments. Similarly, courts should attempt to uphold legislative acts that appear to be public regarding rather than serving only private interests at the expense of the public. Laws should serve some public purpose.

While I am not under the illusion that courts should be expected to police the policy choices of legislatures or displace their constitutional role, courts should be responsible for ensuring that law serves public ends. The public-regarding nature of the Constitution permits judges to use traditional methods of statutory interpretation to play a role in regulating the activities of special interests.<sup>56</sup> The Court in *Winstar* does not even consider its role in ensuring that the government contracts it upholds serve public ends. Had the Court engaged in such an analysis, the exclusively private interest bargain represented in that case could have been exposed and invalidated.

This article has analyzed the *Winstar* case from a public choice perspective. The *Winstar* decision was the culmination of a very long process that began with the creation during the Depression era of an elaborate regulatory infrastructure that nurtured and protected the thrift industry long after it became obsolete as a result of changes in the nature of the mortgage market caused by technological advances. For decades, the assets of thrift institutions consisted of long-term, fixed rate mortgages, that provided neither diversification nor protection from interest rate risk. When competition from other

<sup>55</sup> Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 Colum L Rev 223 (1986) ("Macey, *Promoting Public-Regarding Legislation*"); Jerry L. Mashaw, *Constitutional Deregulation: Notes Toward a Public, Public Law*, 54 Tulane L Rev 849, 849 (1980). See also Richard A. Epstein, *Bargaining With the State* (Princeton, 1993).

<sup>56</sup> Macey, *Promoting Public-Regarding Legislation* at 240-50 (cited in note 55).

sources of capital for housing finance materialized, particularly from mortgage originators who were able to securitize the cash flows associated with mortgage repayments, the thrift industry was unable to respond. Similarly, when interest rates rose, the costs of funding the thrifts' liabilities, which came in the form of short term deposits, increased to the point at which these costs exceeded the revenues associated with the medium and long-term mortgages on the asset side of the thrifts' balance sheets.

In an industry subject to normal market forces, these firms would have re-engineered their operations or faced insolvency. But the thrift regulators were able to shift the costs of this industry-wide, systemic inefficiency by rapidly and dramatically expanding the scope of permissible thrift investment powers to include such things as direct investments in speculative real estate, funded, of course, by federally insured deposits. When this moral hazard led, predictably, to irresponsible risk taking, and shortly thereafter to insolvency, the regulators responded again, this time by weakening the requirements that thrifts maintain adequate capital and reserves as a condition for continued operation. This, of course, simply exacerbated the moral hazard problem, leading to more speculation, and more insolvency. Moreover, one way that the moral hazard manifested itself was in explosive growth by many of the most recklessly managed thrifts. This explosive growth was due to the reduction in required capital and reserves, which permitted thrifts to grow without increasing their capital base. The final move by the regulators in the face of mounting thrift failures during the 1980s was to merge insolvent thrifts into solvent thrifts, promising regulatory forbearance from capital requirements to the healthy institutions that were making these acquisitions. These accounting gimmicks, of course, attracted merger partners that were themselves undercapitalized and interested in taking on risks (with taxpayer money) in the hopes of getting lucky.<sup>57</sup>

The incredible losses associated with this inept, sometimes corrupt, regulation of the thrift industry led to public outrage, and to a serious erosion of the political power of the thrift industry. This, in turn, led to the phenomenon of "coalition drift" described in this article. The coalition in Congress that had supported the thrift industry for decades was no longer willing to associate itself with the industry. Similarly, the bankruptcy of the FSLIC insurance fund led to "bureaucratic drift" of the kind discussed above. Indeed, since

<sup>57</sup> For a discussion of why moral hazard problems should be expected, especially in relation to banking, see Macey & Miller, *Banking Law* at 280-83 (cited in note 23).

the bureaucracy was bankrupt, it literally drifted into oblivion, and was eliminated as a source of further support for the thrift operators.

The result was dramatic legislation to reorganize the regulatory infrastructure of the thrift industry. One major piece of this legislative program, FIRREA, eliminated the special accounting treatment for merged thrifts, which in turn caused a number of thrifts to find themselves suddenly out of compliance with government capital requirements. Facing failure or significant recapitalization costs, these firms sued the government, claiming that the contracts they had made with the thrift regulators had been thwarted by FIRREA. This litigation ultimately produced the Supreme Court opinion in *Winstar*.

The *Winstar* Court validated the shady deals made between the captured regulators of the thrift industry and the thrift operators for whose benefit the regulatory scheme had been created. This decision, in turn, validates the Landes and Posner thesis about the role of the independent judiciary in a rent-seeking society. The opinion in *Winstar* facilitates the rent-seeking process by providing durability and stability to the deals struck between interest groups and politicians. The judiciary in this case permitted the captured regulators to triumph over a subsequent Congress by continuing the benefits of a special-interest group bargain struck between the thrift industry and Congress during the 1930s.

The *Winstar* opinion similarly expands the power of the administrative state by permitting politically unaccountable bureaucrats to tie the hands of Congress. This article makes the point that this opinion actually benefits Congress by increasing the demand by interest groups for legislative wealth transfers. The durability conferred on interest group bargains by the *Winstar* approach to contracts between agencies and interest groups will increase the demand on the part of other interest groups for protectionist regulation. Thus, far from being a decision that promotes efficiency by enforcing contractual commitments, *Winstar* reduces societal welfare by lowering the transaction costs to interest groups of engaging in rent-seeking.